

§ 1.307-2

If the rights are sold, the basis for determining gain or loss will be \$14.7287 per right. If the rights are exercised, the basis of the new stock acquired will be the subscription price paid therefor (\$90) plus the basis of the rights exercised (\$14.7287 each) or \$104.7287 per share. The remaining basis of the old stock for the purpose of determining gain or loss on a subsequent sale will be \$85.2713 per share.

§ 1.307-2 Exception.

The basis of rights to buy stock which are excluded from gross income under section 305(a), shall be zero if the fair market value of such rights on the date of distribution is less than 15 percent of the fair market value of the old stock on that date, unless the shareholder elects to allocate part of the basis of the old stock to the rights as provided in paragraph (a) of § 1.307-1. The election shall be made by a shareholder with respect to all the rights received by him in a particular distribution in respect of all the stock of the same class owned by him in the issuing corporation at the time of such distribution. Such election to allocate basis to rights shall be in the form of a statement attached to the shareholder's return for the year in which the rights are received. This election, once made, shall be irrevocable with respect to the rights for which the election was made. Any shareholder making such an election shall retain a copy of the election and of the tax return with which it was filed, in order to substantiate the use of an allocated basis upon a subsequent disposition of the stock acquired by exercise.

EFFECTS ON CORPORATION

§ 1.312-1 Adjustment to earnings and profits reflecting distributions by corporations.

(a) In general, on the distribution of property by a corporation with respect to its stock, its earnings, and profits (to the extent thereof) shall be decreased by—

- (1) The amount of money,
- (2) The principal amount of the obligations of such corporation issued in such distribution, and
- (3) The adjusted basis of other property.

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For special rule with respect to distributions to which section 312(e) applies, see § 1.312-5.

(b) The adjustment provided in section 312(a)(3) and paragraph (a)(3) of this section with respect to a distribution of property (other than money or its own obligations) shall be made notwithstanding the fact that such property has appreciated or depreciated in value since acquisition.

(c) The application of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example (1). Corporation A distributes to its sole shareholder property with a value of \$10,000 and a basis of \$5,000. It has \$12,500 in earnings and profits. The reduction in earnings and profits by reason of such distribution is \$5,000. Such is the reduction even though the amount of \$10,000 is includible in the income of the shareholder (other than a corporation) as a dividend.

Example (2). The facts are the same as in *Example (1)* above except that the property has a basis of \$15,000 and the earnings and profits of the corporation are \$20,000. The reduction in earnings and profits is \$15,000. Such is the reduction even though only the amount of \$10,000 is includible in the income of the shareholder as a dividend.

(d) In the case of a distribution of stock or rights to acquire stock a portion of which is includible in income by reason of section 305(b), the earnings and profits shall be reduced by the fair market value of such portion. No reduction shall be made if a distribution of stock or rights to acquire stock is not includible in income under the provisions of section 305.

(e) No adjustment shall be made in the amount of the earnings and profits of the issuing corporation upon a disposition of section 306 stock unless such disposition is a redemption.

§ 1.312-2 Distribution of inventory assets.

Section 312(b) provides for the increase and the decrease of the earnings and profits of a corporation which distributes, with respect to its stock, inventory assets as defined in section 312(b)(2), where the fair market value of such assets exceeds their adjusted basis. The rules provided in section 312(b) (relating to distributions of certain inventory assets) shall be applicable without regard to the method used